BANK OF ENGLAND

Speech

Prospects for monetary policy: learning the lessons from 2011

Speech given by

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At Bloomberg, London

13 December 2011

I would like to thank Lai Wah Co, Nick McLaren and Matt Trott for their considerable help in preparing this speech. The views expressed are my own and do not necessarily reflect those of the other members of the Monetary Policy Committee

The obvious temptation when making a speech in mid-December is to use it as an opportunity to look back over the events of the past year. And there is certainly much to reflect upon.

Perhaps the over-whelming sense for many companies and households looking back over 2011 is that it has been a tough year. At best sluggish economic growth in the first half of the year appears to have stalled more recently. Many families have seen their real incomes squeezed, and unemployment has begun to rise again. And these developments at home have played out against a backdrop of increasing tensions and strains within the euro area.

Since I am here at Bloomberg, I thought I'd share a few quotes from the media which capture some of the main themes of the past year:

On fiscal policy: *"Because Britain has taken firm action on the deficit, foreign nations have more faith in our economy and are willing to lend to the UK at more favourable rates*"[1]

On Europe: "*The unpleasant truth is that the whole world would be shaken by an economic meltdown within the European Union*."[2]

And on weaknesses in the banking system: "*A year of economic despair, multibillion euro bailouts*"[3]

Certainly a difficult year.

But in fact all three of these quotes actually date from around this time a year ago. So although a challenging and at times tumultuous year, some features of the economic landscape haven't changed that much. Having said that, the third quote was taken from The News of The World – which was then our biggest selling Sunday newspaper.

Much else has changed over the past year. Not least the outlook for growth. This time last year, the MPC judged there to be roughly only a 1 in 7 chance that four-quarter GDP growth in 2011 Q3 would be as weak or weaker than the current ONS estimate of 0.5% (Chart 1).

There are two key questions about the changing economic environment that I would like to consider this morning. First, why has growth over the past year been so much weaker than the MPC expected? And second, why has the economic outlook deteriorated so significantly in recent months?

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[1] Yes, it's bleak...but don't panic yet, Daily Mail, 26th January 2011
[2] No escape from Europe's debt crisis, Financial Times, 6th December 2010
[3] Let's put that year behind, News of the World, 26th December 2010

But I'm going to avoid the temptation just to look back.

In response to the weakening outlook, the MPC voted in October to purchase an additional £75 billion of assets. Having decided to inject this further round of monetary stimulus, I would like to say a few words about how we think asset purchases work, and in particular address some of the concerns and criticisms often levelled at QE.

And as we look to 2012 and beyond, I'll consider some of the key challenges facing the UK economy, and monetary policy in particular.

Learning the lessons from 2011

But let's start with the disappointing performance of our economy during 2011 and the two questions I flagged.

First, why has growth over the past year been so much weaker than expected a year ago?

The expectation that the economy during 2011 would continue to grow at the relatively solid rates seen during the middle of 2010 was based in part on the belief that we would see a gradual rebalancing of our economy towards net trade. Sterling then – as now – was around 25% lower than its level in mid-2007. That more competitive exchange rate, combined with a recovery in global demand, was expected to underpin a gradual strengthening in our trade balance.

A common perception is that the support provided by the lower level of sterling has been disappointing. But I'm not sure that view is entirely warranted. The UK's real trade deficit has almost halved as a share of GDP since mid-2007, from around 3.0% to 1.6% in 2011 Q3. Of course, whether this improvement in the UK's external balance can be sustained as spare capacity in the economy is used up, and we start to suck in more imports, remains to be seen. The road to rebalancing has a good few miles left to run. But some progress has been made.

Indeed, the turnaround in net trade has been broadly in line with developments following previous large sterling movements. But that disguises some significant variation across different markets. Within exports, the fall in sterling has been instrumental in arresting the trend decline in our share of the world market for goods exports (Chart 2). But exports of services, especially financial services, have been weak. Likewise, sterling's fall has led to the previously persistent upward trend in import penetration flattening off (Chart 3). But this has largely been driven through a switch in spending on travel and tourism – the "stay-cation" effect. There is less evidence of a shift in expenditure away from imports of goods and other services.[4]

[4] A more detailed account of the recent improvement in net trade can be found in "Understanding recent developments in UK trade" by Kishore Kamath and Varun Paul, forthcoming in the 2011 Q4 *Quarterly Bulletin* (published on 19 December).

Although the extent of the improvement has varied across different types of trade, all told, net trade contributed 1.3% to annual GDP growth in 2011 Q3. That compares with an average contribution over the past 50 years or so of zero.

So, if not net trade, what does account for the disappointing growth performance?

A good chunk of the answer lies in the weakness of company spending over the past year or so. Taken together, spending by companies on investment and inventories actually fell slightly in the year to 2011 Q3, whereas we had expected steady growth.

But the main reason for the unexpected weakness is the sharp fall in household consumption over the past year. Consumer spending is estimated to have fallen by over 1% in the first half of 2011 alone, far weaker than the MPC had expected. Remember, household spending accounts for over sixty percent of total demand in our economy. It is hardly surprising that the pace of the recovery has been so muted, when the dominant component of demand has been in a tailspin.

To my mind the surprising weakness in consumption stemmed largely from the sharp pickup in inflation over the past year, driven by increases in VAT, energy prices (including higher gas and electricity prices) and other import prices. CPI inflation over the past year was significantly higher than we had expected (Chart 4). And with modest earnings growth, these price increases detracted directly from households' purchasing power, and the impact on the high street was plain to see.

The weakness in consumption adds weight to the argument that not all of our disappointing growth performance can be laid at the door of the euro crisis. But neither does it imply that it stems from domestic headwinds. Rather, much of the weakness can be related to the unavoidable fall in our real living standards as the cost of energy and other goods and services we import from abroad rose in price.

So why didn't the Committee respond to this increase in inflation? It is true that monetary policy could have been tightened to offset these price increases and keep inflation closer to target. But only at the expense of generating an even deeper recession and an even bigger hit to households' incomes. If the cost of the goods and services we import from the rest of the world go up in price, our real living standards have to fall. There is no magic wand that the MPC can wave that can avoid that painful fact.

Although the euro crisis might not account for the weakness evident over much of the past year, I do fear that the dark cloud hanging over the other side of the channel is casting a growing shadow over our economy. That leads me to my second question: why has the economic outlook deteriorated so significantly in recent months?

And to be clear, the near-term outlook has weakened very materially. The MPC's central projection for GDP growth in 2012 published in last month's *Inflation Report* was over 2% points weaker than the corresponding projection a year ago, with much of that mark down happening over the past 3 months.

Although the precise reasons why the economy appears to have slowed are uncertain, and we can't rule out some intensification of domestic headwinds, the most likely explanation would seem to be the growing fallout from the euro area as it has lurched from one mini crisis to another. The growing malaise within the euro zone has affected our economy in a variety of ways.

Although exports had already begun to fall in Q2 of this year, lower goods exports to EU countries drove a further decline in the third quarter.

The ability of banks to fund themselves has become increasing constrained since the summer. My sense, based in part on the evidence collected by the Bank's network of Agents, is that this has not yet led to a renewed tightening in the credit conditions faced by most companies and households. But the risk is that it will, unless strains within the banking system ease and ease quickly.

More generally, the spectre of a further leg to the financial crisis has caused a sharp loss in business and household confidence. Faced with such uncertainty, businesses may choose to shelve their investment plans for a while; and even those families fortunate enough to be in the position to contemplate buying a new TV or sofa may decide to take five. At the level of an individual firm or family, such caution in the face of increased uncertainty is perfectly understandable. But at an aggregate level, it can equate to a sharp slowing in spending and demand.

How deep and persistent this slowing in growth is likely to be is very hard to know. Business surveys suggest that the recovery is likely to have come to a standstill in the final quarter of this year. My central view is that growth is likely to remain very weak during the first half of next year, before gaining some traction thereafter as the squeeze on households' real incomes comes to an end. But this depends on the euro zone being able to implement a credible and effective response to the substantial challenges it faces. Failure to do so, poses the single biggest threat to our recovery.

QE myth busting

It was this weakening in economic prospects, and the consequent shift in the outlook for inflation, which underpinned the Committee's decision in October to undertake a further round of asset purchases. I would be the first to admit that we are uncertain about the relative strength of the mechanisms through which QE works, and about its precise impact on the economy. That is true of almost all public policy actions. But particularly so for the MPC's asset purchase programme which effectively breaks new ground for UK monetary policy.

But some of the concerns and criticisms commonly expressed about QE are less well founded than others. So although I hesitate to take on the mantle of a modern day Ghostbuster, I do think there would be value in some QE myth busting. I want to take aim at five myths in particular, and again, in deference to our surroundings, I thought I would illustrate each one with an appropriate quote from the media.

The first myth argues that the QE undertaken by the Committee is indicative of a more cavalier approach towards hitting our 2% inflation target:

"QE has cast serious doubt on the Bank's promise to maintain its 2% inflation target. UK inflation has overshot the target for 51 of the past 60 months" *(Wall Street Journal, 14/10/11).*

Yes: QE is inflationary. And yes, inflation would almost certainly have been lower had we not undertaken the first round of asset purchases in 2009. But no, that does not mean that the MPC is any less determined to bring inflation back to target. Indeed, quite the opposite.

Our fear in 2009 – as it is now – was that if the recovery faltered and our economy fell into a further prolonged recession, underlying inflationary pressures in our economy would weaken and there would be a risk that inflation would materially undershoot the inflation target in the medium term.

As you all well know, in the event we were surprised by the subsequent strength of price pressures coming from outside of the UK private sector, from energy and other import prices, and more recently from the increase in VAT, which drove inflation far higher than we had expected. As many of my colleagues have explained in the past, those external price level shocks should have only a temporary impact on inflation.[5] As I just argued, to have offset this sequence of price level shocks would have meant consciously generating an even deeper recession, which would have led to an even bigger undershoot of the inflation target further out.

[5] See, for example, Bean (2011), King (2011) and Miles (2011).

I'm not saying that if I had had perfect foresight, I wouldn't have changed my policy stance at all over this period. But the hurdle for wanting to have had materially tighter policy in the face of the most severe downturn in the post-war period seems pretty high to me.

The second criticism often levelled at the MPC's asset purchase programme is that it comes at the expense of savers:

"QE2 will further sacrifice the financial health of pension funds, pensioners and savers" *(The Guardian, 7/10/11).*

I have the utmost sympathy for the hardship faced by many pensioners and other households dependent on the flow of income from their savings. They played no role in fuelling the financial crisis, but have been badly hit by the reduction in interest rates that followed. I understand that the burden of interest rate cuts falls most heavily on savers. And I can understand why, to many, it seems unfair that those with high levels of debt and borrowing should now benefit from lower rates.

But what was the alternative? I have no doubt that, had monetary policy not responded so aggressively, our economy would have fallen into a far deeper and longer recession. The impact of that would have been far reaching, not just for those with high levels of debt but for everyone in our society, including pensioners and savers. Dividend payments from UK companies, which provide an important source of income for many savers, would have been hit. The value of savings and wealth invested in financial assets would have fallen by far more than they did; the same is also true for house prices.

Savers and pensioners in our society have much to be angry about. But I'm not sure that anger is best directed at monetary policy.

A third commonly voiced concern is that the latest round of asset purchases will be less effective than the first because gilt yields are already so low:

"[QE] will not achieve much, given how low yields already are" *(Financial Times, 14/10/11).*

I think this concern is misplaced. Although yields on short-dated gilts have little scope to fall further, that is less true for longer-term yields.

More fundamentally, the aim of QE is not to reduce government borrowing costs. It is to reduce the borrowing costs faced by UK companies and households. The spread of these borrowing costs over gilt yields has widened in recent months as euro zone tensions have increased, risk appetites have shrunk and there has been a general flight to safety. Our asset purchases directly push back against that tendency: reducing the supply of gilts and encouraging investors to reallocate their portfolios into more risky assets, such as corporate bonds and equities. And in so doing, they should help to reduce the cost, and increase the availability, of lending to larger companies.

It is precisely in times of heightened risk and increased spreads that QE has the potential to do most good.

The myth I would most like to bust is that QE might not work because the money will get stuck in the banks:

"The money could simply sit in the banks, doing nothing" *(BBC News, 11/3/09).*

I find this a particularly frustrating myth because we have tried hard to dispel it, but it keeps coming back. Those of you old enough to remember Ghostbusters, may recall that the weapon of choice for the intrepid busters was the so-called Dematerializer. The only problem with the Dematerializer was that it did not work against the most powerful ghosts, such as Prime Evil or Voodon, the voodoo monster. I fear that this myth is our voodoo monster. So let me take careful aim.

The asset purchase programme was explicitly designed to go *around* the banking system, not *through* it. In 2009, we initially avoided buying shorter-dated gilts since these were the gilts that banks tended to hold. But in fact, at the time we started QE, UK banks in total owned only around £25bn of gilts. We purchased £200 billion of gilts!

Our analysis suggests that a vast majority of the gilts that we purchased would otherwise have been held by UK institutional investors, such as insurance companies and pension funds. As long as those investors were not indifferent to holding cash rather than interest-bearing gilts – which they appear not to have been – the portfolio reallocation triggered by the MPC's asset purchases should increase demand for other types of assets, including UK corporate bonds and equities.[6] It is no co-incidence that in 2009 – close to the depths of the recession – UK companies issued more corporate bonds and more equities than in any year, either before or since.

There are many reasons why QE may not have the impact we hope or expect. But I do not think that the money getting stuck in the banks is one of them.

The final criticism I would like to address is the suggestion that the MPC should have purchased more private sector assets in order to provide greater support to businesses:

[6] By purchasing gilts from the non-bank private sector (nbps), the Committee's asset purchases should boost broad money, i.e. in the form of bank deposits held by the nbps. Those deposits are available to institutions and companies to purchase other financial assets, finance investment projects etc. In no sense is the money "stuck" in the banks.

"it would be more effective if the MPC was prepared to purchase private sector assets. This could help improve the availability of credit to businesses" *(Daily Telegraph, 23/11/11).*

Much of this criticism has been directed as the importance of improving the flow of credit to small and medium-sized enterprises.

I have considerable sympathy for the argument that the MPC's asset purchase programme provides relatively limited direct support to SMEs. It will provide indirect support by stimulating spending and activity in our economy. But most SMEs are heavily dependent on bank credit and so not able to benefit directly from the increased demand for corporate debt and equity triggered by our asset purchases.

But therein lies the problem. The majority of SMEs do not issue marketable securities that the MPC could purchase. The median UK company that issued a corporate bond in 2010 employed more than 20,000 people and had an operating income of more than £300 million.[7] Buying more corporate bonds would provide little help to SMEs.

Instead, we need to find ways to incentivise the banks to lend more to SMEs. That is exactly the aim of the credit easing policies that the Chancellor announced in his Autumn Statement last month. I very much hope that those schemes are able to improve the flow of credit to smaller companies.

Let me stop there on QE myths. I have tried to clarify some of the more popular misconceptions surrounding QE. But I don't want to pretend that QE is the answer to all our economy's problems. And I certainly wouldn't want to suggest that we know with any precision how big the impact from our asset purchases will be.

A recent article in the Bank's Quarterly Bulletin summarised research by Bank economists which suggests that the first round of asset purchases had a significant positive impact on the level of output and inflation in the UK (Joyce et al. 2011). But there is considerable uncertainty as to exactly how big that effect was. And there are many reasons why the impact of the latest round of purchases may be either bigger or smaller. So, although I am confident that QE will continue to provide substantial support to the economy, we need to remain alert to our uncertainty concerning the precise mechanisms through which it works and its ultimate impact.

7 Estimate derived from financial statements from Thomson Reuters Worldscope and capital issuance data from Dealogic.

Looking ahead to 2012

I would like to finish today by looking ahead to the economic events that are likely to shape the next year. What will be the over-whelming sense of companies and households when they look back over 2012?

For many of us that is likely to depend heavily on events on the other side of the channel. Will the plans announced last week come to be seen as a decisive step towards an effective and credible response to the substantial challenges facing the euro zone? There are limits to what domestic monetary policy can do to insulate our economy from such external events. I expect that developments within the euro zone will continue to have an important bearing on our economic fortunes for some time to come.

2012 should also be remembered as the year in which inflation fell sharply.

When considering the outlook for inflation over the next year or so, I find it helpful to separate it into two separate phases.

The first phase is the period between now and next March or so, during which CPI inflation should fall rapidly as the price level increases we saw around this time last year – from the VAT rise and the increases in petrol prices – drop out of the twelve-month inflation rate. These base effects alone should pull down on inflation by between 1.5 to 2.0 percentage points by the end of 2012 Q1.[8] Barring some large and unanticipated price increases, CPI inflation looks set to come down to the low 3's by March next year.

But it's important to recognise that the fall in inflation over the next few months is not likely to shed much light on the persistence of inflation beyond that. The base effects are already baked in the cake. And their size is likely to swamp any developments in current price pressures. The behaviour of inflation in the second phase, from the spring of 2012 onwards, is far more uncertain and far more important for the future stance of monetary policy.

How far and how fast will inflation fall once the base effects have dropped out?

In the *Inflation Report* published last month, the best collective judgement of the MPC was that inflation was likely to fall to below the 2% target by the end of next year, with the balance of risks throughout 2013 weighted quite heavily towards inflation being below target.

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[8] See Chart 4.2 on Page 34 of the November 2011 *Inflation Report* for more details.

Although I also expect inflation to continue to fall through 2012, my own view is that the chances of inflation being above or below the target by the end of next year and into 2013 are a little more balanced. There is certainly a possibility that inflation could fall significantly below the target, especially if demand turns out to be weaker than we expect. But there is also a risk – especially in the absence of an escalation of the euro area crisis – that inflation could prove to be more persistent. Companies' and households' inflation expectations may not fall as quickly as anticipated. Productivity growth may continue to disappoint. Businesses may attempt to rebuild their margins by raising prices. The upward impetus from import prices may persist.

I hope and expect that 2012 will come to be seen as the year in which inflation fell back. And in so doing, the hardships faced by many households from the squeeze in their real incomes eased. But exactly how much inflation will subside is uncertain and, importantly, will only become clearer once the base effects have dropped out and we are able to get a better sense of underlying price pressures.

One thing I know for sure is that – just as this year – we will be surprised. By events, by the behaviour of companies and households, by how the economy develops. As policymakers we will need to remain open and pragmatic, mindful of how little we know about the economy and about how it is likely to evolve. Importantly, we have the tools at our disposal to adjust the stance of policy, in either direction, as the outlook changes.

There is certainly scope, if necessary, for us to increase our programme of asset purchases. Indeed, there are more gilts outstanding now than when we first started QE in March 2009.

The more binding constraint might be if the credibility of asset purchases started to be questioned. But that is likely to depend on the economic circumstances rather than the scale of purchases per se. There is a growing body of evidence that the large scale asset purchases conducted in both the UK and the US supported economic activity in the period following the financial crisis. And, as I argued earlier, there are good reasons to think that it will provide valuable support in the current environment of weak external demand and heightened uncertainty.

Likewise, I am confident that we will be able to exit from the current period of exceptional policy as and when we need to. In the near term, with markets not pricing in a rise in Bank Rate until the second half of 2014, there is considerable scope for the stance of policy to tighten simply by the expected timing of future rate increases being brought forward. And the MPC is committed to selling back the gilts it has purchased as part of its asset purchase programme as the recovery takes hold and the economy begins to normalise.

I don't know what the headlines will be in December 2012. But I do know that the MPC then, as now, will be focussed on keeping inflation on track to hit our target of 2%.

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Charts

Chart 1: November 2010 GDP projection based on market interest rate expectations and £200 billion asset purchases, and the latest vintage of GDP data

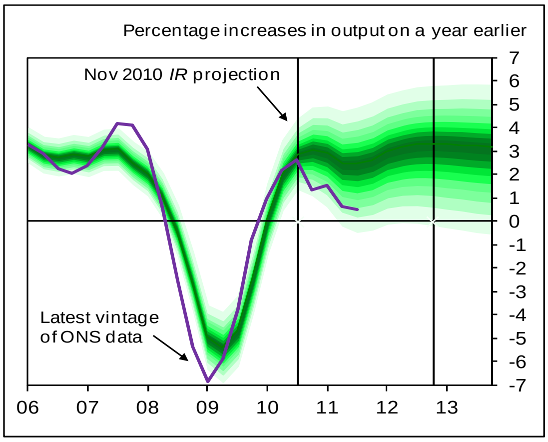
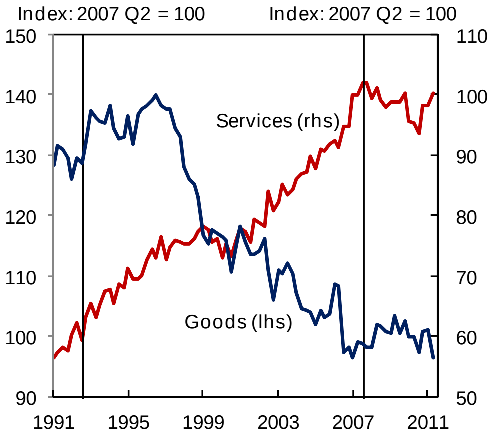


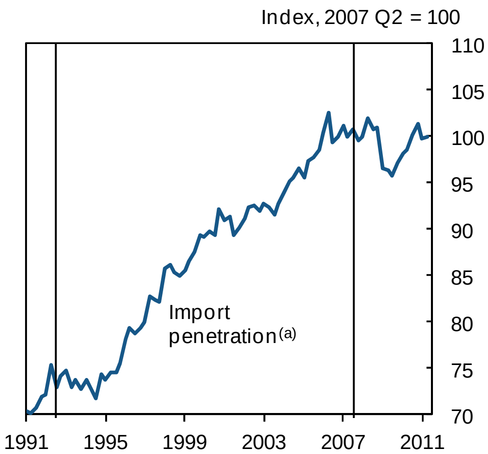
Chart 2: UK goods and services world export market shares[(a)]



Sources: ONS and Bank calculations.

(a) Chained-volume measures excluding the estimated impact of MTIC fraud. UK goods (services) exports divided by imports of goods (services) in Canada, France, Germany, Italy, Japan and the United States, weighted using UK 2010 goods (services) export shares from the 2011 Pink Book. The last observation is 2011 Q2. The vertical lines show the start of the two most recent large depreciations of sterling.

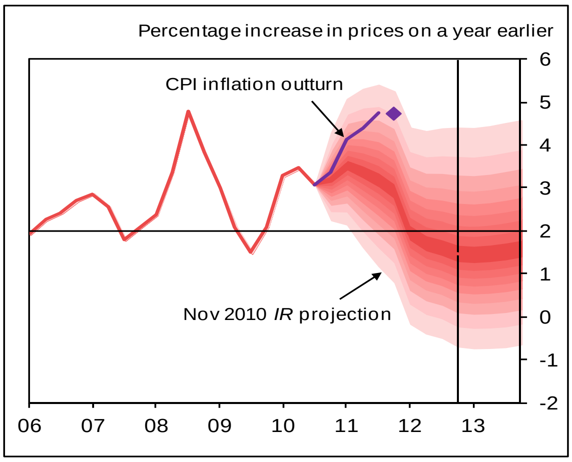
Chart 3: UK import penetration



Sources: ONS and Bank calculations.

(a) Imports as a proportion of import-weighted total final expenditure. Import-weighted total final expenditure is calculated by weighting household consumption (including non-profit institutions serving households), whole-economy investment (excluding valuables), government spending, stockbuilding (excluding the alignment adjustment), and exports by their respective import intensities. Import and export data have been adjusted to exclude the estimated impact of MTIC fraud. Import intensities are estimated using the United Kingdom Input-Output Analytical Tables 2005. The last observation is 2011 Q2. The vertical lines show the start of the two most recent large depreciations of sterling.

Chart 4: November 2010 CPI inflation projection based on market interest rate expectations and £200 billion asset purchases, and the CPI inflation outturn[(a)]



(a) The diamond shows the November 2011 central CPI projection for 2011 Q4